

Auditing Procedures Report

Issued under P.A. 2 of 1968, as amended and P.A. 71 of 1919, as amended.

Local Unit of Government Type <input type="checkbox"/> County <input type="checkbox"/> City <input type="checkbox"/> Twp <input type="checkbox"/> Village <input checked="" type="checkbox"/> Other				Local Unit Name City of Ann Arbor Retiree Healthcare Trust		County Washtenaw	
Fiscal Year End 6/30/06		Opinion Date 9/27/06		Date Audit Report Submitted to State 12/22/06			

We affirm that:

We are certified public accountants licensed to practice in Michigan.

We further affirm the following material, "no" responses have been disclosed in the financial statements, including the notes, or in the Management Letter (report of comments and recommendations).

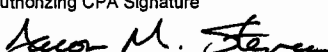
YES ☒ NO ☐

Check each applicable box below. (See instructions for further detail.)

1. ☒ ☐ All required component units/funds/agencies of the local unit are included in the financial statements and/or disclosed in the reporting entity notes to the financial statements as necessary.
2. ☒ ☐ There are no accumulated deficits in one or more of this unit's unreserved fund balances/unrestricted net assets (P.A. 275 of 1980) or the local unit has not exceeded its budget for expenditures.
3. ☒ ☐ The local unit is in compliance with the Uniform Chart of Accounts issued by the Department of Treasury.
4. ☒ ☐ The local unit has adopted a budget for all required funds.
5. ☒ ☐ A public hearing on the budget was held in accordance with State statute.
6. ☒ ☐ The local unit has not violated the Municipal Finance Act, an order issued under the Emergency Municipal Loan Act, or other guidance as issued by the Local Audit and Finance Division.
7. ☒ ☐ The local unit has not been delinquent in distributing tax revenues that were collected for another taxing unit.
8. ☒ ☐ The local unit only holds deposits/investments that comply with statutory requirements.
9. ☒ ☐ The local unit has no illegal or unauthorized expenditures that came to our attention as defined in the *Bulletin for Audits of Local Units of Government in Michigan*, as revised (see Appendix H of Bulletin).
10. ☒ ☐ There are no indications of defalcation, fraud or embezzlement, which came to our attention during the course of our audit that have not been previously communicated to the Local Audit and Finance Division (LAFD). If there is such activity that has not been communicated, please submit a separate report under separate cover.
11. ☒ ☐ The local unit is free of repeated comments from previous years.
12. ☒ ☐ The audit opinion is UNQUALIFIED.
13. ☒ ☐ The local unit has complied with GASB 34 or GASB 34 as modified by MCGAA Statement #7 and other generally accepted accounting principles (GAAP).
14. ☒ ☐ The board or council approves all invoices prior to payment as required by charter or statute.
15. ☒ ☐ To our knowledge, bank reconciliations that were reviewed were performed timely.

If a local unit of government (authorities and commissions included) is operating within the boundaries of the audited entity and is not included in this or any other audit report, nor do they obtain a stand-alone audit, please enclose the name(s), address(es), and a description(s) of the authority and/or commission.

I, the undersigned, certify that this statement is complete and accurate in all respects.

We have enclosed the following:		Enclosed	Not Required (enter a brief justification)	
Financial Statements		<input checked="" type="checkbox"/>		
The letter of Comments and Recommendations		<input checked="" type="checkbox"/>		
Other (Describe) None		<input checked="" type="checkbox"/>	N/A	
Certified Public Accountant (Firm Name) Abraham & Gaffney, P.C.			Telephone Number 517-351-6836	
Street Address 3511 Coolidge Road, Suite 100			City East Lansing	State MI
			Zip 48823	
Authorizing CPA Signature 		Printed Name Aaron M. Stevens, CPA		License Number 1101024055

**CITY OF ANN ARBOR
RETIREE HEALTH CARE BENEFITS
PLAN AND TRUST**

FINANCIAL STATEMENTS

Fiscal Years Ended June 30, 2006 and 2005



Issued by: Retirement System, 301 E. Liberty Street, Suite 680, Ann Arbor, Michigan 48104
(734) 994-4590

City of Ann Arbor
Retiree Health Care Benefits Plan and Trust

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Principals

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Michael T. Gaffney, CPA
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INDEPENDENT AUDITOR'S REPORT

To the Board of Directors
of the City of Ann Arbor
Retiree Health Care Benefits Plan and Trust

We have audited the accompanying statement of plan net assets of the City of Ann Arbor Retiree Health Care Benefits Plan and Trust as of June 30, 2006, and the related statement of changes in plan net assets for the year then ended. These financial statements are the responsibility of the Plan's management. Our responsibility is to express an opinion on these financial statements based on our audit. The financial statements of the City of Ann Arbor Retiree Health Care Benefits Plan and Trust as of and for the year ended June 30, 2005 were audited by other auditors, whose report dated October 21, 2005 expressed an unqualified opinion on those statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note A, the financial statements present only the City of Ann Arbor Retiree Health Care Benefits Plan and Trust and do not purport to, and do not present fairly the financial position of the City of Ann Arbor, Michigan, and the changes in its financial position for the years then ended in conformity with accounting principles generally accepted in the United States of America.

In our opinion, the financial statements referred to above present fairly, in all material respects, the plan net assets of the City of Ann Arbor Retiree Health Care Benefits Plan and Trust as of June 30, 2006, and the changes in its plan net assets for the year then ended in conformity with accounting principles generally accepted in the United States of America.

The management's discussion and analysis, as identified in the Table of Contents, is not a required part of the financial statements but is supplementary information required by the Governmental Accounting Standards Board. We have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Abraham & Gaffney, P.C.

ABRAHAM & GAFFNEY, P.C.
Certified Public Accountants

September 27, 2006

City of Ann Arbor
Retiree Health Care Benefits Plan and Trust

MANAGEMENT'S DISCUSSION AND ANALYSIS

June 30, 2006 and 2005

The following is a discussion and analysis of the City of Ann Arbor Retiree Health Care Benefits Plan and Trust's financial performance and position, providing an overview of the activities for the year ended June 30, 2006. This analysis should be read in conjunction with the *Independent Auditors Report* and with the accompanying financial statements.

The City of Ann Arbor Voluntary Employees Beneficiary Association (VEBA; the "Plan") is a single-employer defined benefit post employment healthcare plan established and administered by the City of Ann Arbor through the Board of Trustees of the Retiree Health Care Benefits Plan and Trust to provide health and life benefits for retirees and their beneficiaries.

Using this Annual Report

This annual report consists of two parts: (1) management's discussion and analysis (this section) and (2) the financial statements. The financial statements also include notes that explain some of the information in the financial statements and provide more detailed data.

Condensed Financial Information

The table below compares key financial information in a condensed format between the current year and the prior year:

	Fiscal Year Ended June 30,	
	<u>2006</u>	<u>2005</u>
Total assets	\$ 55,698,733	\$ 45,154,444
Total liabilities	<u>37,779</u>	<u>194,104</u>
Net assets held in trust for healthcare benefits	55,660,954	44,963,340
Net investment gain	3,650,285	3,273,074
Contributions - employer	7,065,913	4,099,025
Retiree health benefits paid	<u>-</u>	<u>-</u>
Contributions in excess of benefits paid	7,065,913	4,099,025
General and administrative expenses	<u>18,584</u>	<u>19,348</u>
Net change in plan net assets	<u>\$ 10,697,614</u>	<u>\$ 7,352,751</u>

Overall Fund Structure and Objectives

The City of Ann Arbor VEBA Trust exists to pay health care benefits to retired members. The Plan is currently accumulating assets to generate investment earnings and there are no benefits currently being paid. The excess of contributions over benefits paid will allow for additional funding to increase investment income to a level where the Plan will generate adequate earnings to pay future benefits. The public capital markets represent the primary source of investments.

City of Ann Arbor
Retiree Health Care Benefits Plan and Trust

MANAGEMENT'S DISCUSSION AND ANALYSIS

June 30, 2006 and 2005

Asset Allocation

It is the responsibility of the VEBA Board to determine the allocation of assets among distinct capital markets in accordance with allowable legal limits. Based on an asset allocation review conducted in 2006, which analyzed the expected returns of various asset classes, the Plan's actuarial assumption rate, and the risks associated with alternative asset mix strategies, the Board has established the following asset allocation:

<u>Asset Class</u>	<u>Target</u>	<u>Range</u>
Domestic Equity	65%	55-65
Fixed Income	30%	30-40
Real Estate	5%	0-10

The study has shown that this asset mix offers the optimal mix for meeting longer term goals. The asset classes stated above shall be further diversified (where possible) as to style and manager type to reduce risk further, while providing the opportunity for enhanced return.

Economic Factors, Investment Returns, and Other Important Matters

In 2005/06, the U.S. stock market continued its recent growth following its previous decline. Led by a continued increase in productivity and by a sustained level in capital investment and inventory rebuilding, the equity markets provided investors with a positive rate of return. However, the short-term economic outlook remains cautious due to the continued uncertainty about future interest rate levels and oil product supply availability and price.

The Plan's investment return must always be considered in a longer-term context. The asset allocation is built upon the foundation that the obligations of the Plan to pay the benefits promised to members and retirees are very long-term obligations. Accordingly, the Board of Trustees must make investment decisions that it believes will be the most beneficial to the Plan over many years, not just one or two years.

The Plan is funded by contributions from the City of Ann Arbor with the intention of reaching a fully funded status within the next several years. VEBA members are not required to contribute to the Plan. Current retiree medical and life benefits are budgeted and paid for out of various City of Ann Arbor departments. The City is reimbursed for these costs pursuant to annual resolutions providing for reimbursement of these costs under Act 28 of Public Acts of 1966, which allows the Employees Retirement System to pay current retiree health and life benefits from investment earnings on employer assets in excess of the actuarial rate of return. An actuary performs this calculation annually, and the amount reimbursed is within the maximum amount allowed.

Contacting the Plan Management

This financial report is intended to provide our citizens, taxpayers, and investors with a general overview of the Plan's finances and to show accountability for the money received. If you have questions about this report or need additional information, we welcome you to contact the City of Ann Arbor Retiree Health Care Benefits Plan and Trust Office at 301 East Liberty Street, Suite 680, Ann Arbor, Michigan 48104, or (734) 994-4590.

CITY OF ANN ARBOR
RETIREE HEALTH CARE BENEFITS PLAN AND TRUST

STATEMENT OF PLAN NET ASSETS

June 30, 2006 and 2005

	<u>2006</u>	<u>2005</u>
ASSETS		
Equity in pooled cash and investments	\$ 1,554	\$ 1,426,088
Investments, at fair value	55,541,843	43,594,253
Accrued interest and dividends	155,336	123,794
Due from other governmental units	<u>-</u>	<u>13,309</u>
Total assets	55,698,733	45,157,444
LIABILITIES		
Accounts payable	<u>37,779</u>	<u>194,104</u>
NET ASSETS		
Held in trust for healthcare benefits	<u>\$ 55,660,954</u>	<u>\$ 44,963,340</u>

See accompanying notes to financial statements

CITY OF ANN ARBOR
RETIREE HEALTH CARE BENEFITS PLAN AND TRUST

STATEMENT OF CHANGES IN PLAN NET ASSETS

Years Ended June 30, 2006 and 2005

	<u>2006</u>	<u>2005</u>
ADDITIONS TO NET ASSETS		
Investment income		
Interest and dividends	\$ 1,517,575	\$ 1,199,783
Net appreciation in fair value of investments	<u>2,302,136</u>	<u>2,248,945</u>
	3,819,711	3,448,728
Less: investment expense	<u>(169,426)</u>	<u>(175,654)</u>
Net investment income	3,650,285	3,273,074
Contributions		
Employer	<u>7,065,913</u>	<u>4,099,025</u>
Total additions to net assets	10,716,198	7,372,099
DEDUCTIONS FROM NET ASSETS		
Administrative expense	<u>18,584</u>	<u>19,348</u>
CHANGE IN PLAN NET ASSETS	10,697,614	7,352,751
Net assets - beginning of year	<u>44,963,340</u>	<u>37,610,589</u>
Net assets - end of year	<u><u>\$ 55,660,954</u></u>	<u><u>\$ 44,963,340</u></u>

See accompanying notes to financial statements

City of Ann Arbor
Retiree Health Care Benefits Plan and Trust

NOTES TO FINANCIAL STATEMENTS

June 30, 2006 and 2005

NOTE A: PLAN DESCRIPTION

The City of Ann Arbor Voluntary Employees Beneficiary Association (VEBA; the "Plan") is a single-employer defined benefit post employment healthcare plan established and administered by City of Ann Arbor through the Board of Trustees of the Retiree Health Care Benefit Plan & Trust to provide health and life benefits for retirees and their beneficiaries.

The Plan is funded by contributions from the City of Ann Arbor with the intention of reaching a fully funded status within the next several years, under a trust agreement established pursuant to Section 501(c)(9) of the Internal Revenue Code, which allows for the formation of a VEBA. This fund is included as a pension trust fund in the City's basic financial statements.

VEBA members are not required to contribute to the Plan. Employer contributions for the year ended June 30, 2006 were \$7,065,913.

Current retiree medical and life benefits are budgeted and paid for out of various City of Ann Arbor departments. The City is reimbursed for these costs pursuant to annual resolutions providing for reimbursement of these costs under Act 28 of Public Acts of 1966, which allows the Employees Retirement System to pay current retiree health and life benefits from investment earnings on employer assets in excess of the actuarial rate of return. An actuary performs this calculation annually, and the amount reimbursed is within the maximum amount allowed.

NOTE B: SIGNIFICANT ACCOUNTING POLICIES

Basis of Accounting. The VEBA statements are prepared using the accrual basis of accounting. Employer contributions are recognized in the period that the contributions are due.

Method Used to Value Investments. Plan investments are reported at fair value. Short-term investments are reported at cost, which approximates fair value. Securities traded on national exchanges are valued at the last reported sales price. Investments that do not have an established market are reported at estimated fair values.

Administration. Administrative costs are financed through the Plan's investment earnings.

NOTE C: DEPOSITS AND INVESTMENTS

The Michigan Public Employees Retirement Systems' Investment Act, Public Act 314 of 1965, as amended, authorizes the Plan to invest in stocks, government and corporate securities, mortgages, real estate, and various other investment instruments, subject to certain limitations. The Plan's Board has the responsibility and authority to oversee the investment portfolio. Various professional investment managers are contracted to assist in managing the Plan's assets. All investment decisions are subject to Michigan law and the investment policy established by the Board.

The Plan's investments are held by independent investment management companies. Following is a summary of the Plan's investments as of June 30, 2006:

	<u>Fair Value</u>	<u>Cost</u>
Common Stocks	\$ 35,315,843	\$ 32,719,650
Corporate Bonds	15,812,847	16,467,081
Money Market Funds	1,494,018	1,494,018
Real Estate - Direct and Funds	<u>2,919,135</u>	<u>2,714,425</u>
Total investments	<u>\$ 55,541,843</u>	<u>\$ 53,395,174</u>

City of Ann Arbor
Retiree Health Care Benefits Plan and Trust

NOTES TO FINANCIAL STATEMENTS

June 30, 2006 and 2005

NOTE C: DEPOSITS AND INVESTMENTS - CONTINUED

Interest Rate Risk

For investments, the risk that changes in interest rates will adversely affect the fair value of the investment is known as interest rate risk. The Plan's investment policy provides for securities with terms to maturity of up to 30 years. None of the investments held by the Plan as of June 30, 2006 are subject to interest rate risk.

Credit Risk

Credit risk is the risk that an issuer or other counterparty to an investment will not fulfill its obligations. The Plan's investment policy provides that corporate bonds rated lower than BBB by Standard & Poor's should be limited to 10% of the investment portfolio. The corporate bonds are in an index fund, and are not rated. The Plan has no investments that are rated as to risk category at June 30, 2006.

Custodial Credit Risk

For investments, custodial credit risk is the risk that, in the event of the failure of the counterparty, the Plan will not be able to recover the value of its investments or collateral securities that are in the possession of an outside party. The Plan's investment policy requires that investment securities be held in trust by a third-party institution in the Plan's name. As such, although uninsured and unregistered, the Plan's investments are not exposed to custodial credit risk since the securities are held by the counterparty's trust department in the Plan's name. Short-term investments in money market funds are not subject to custodial credit risk.

Concentration of Credit Risk

The Plan's Board has established ranges for investment asset allocation as follows:

<u>Asset Class</u>	<u>% Range</u>
Equities	55-65
Fixed Income	30-40
Real Estate	0-10

Also, at the time of purchase, no more than 5% of the equity securities of a single issuer may be owned, and no security should be more than 5% of the total portfolio at market value.

Additionally, the State of Michigan Public Employee Retirement System Investment Act limits domestic equity participation to no more than 70% of the total fund market value and international investments to 20% of total fund market value. The investments are listed above and no individual investment exceeds these concentration parameters.

NOTE D: UPCOMING REPORTING CHANGE

In April 2004, the Governmental Accounting Standards Board released Statement Number 43, *Financial Reporting for Postemployment Benefit Plans Other Than Pension Plans*. The new pronouncement provides guidance for employee benefit plans that will require changes to the financial statement presentation and notes to the financial statements. The pronouncement will also require that actuarial information about the Plan be disclosed as Required Supplementary Information in the financial statements. The new pronouncement is effective for the year ending June 30, 2007.

City of Ann Arbor
Retiree Health Care Benefits Plan and Trust

NOTES TO FINANCIAL STATEMENTS

June 30, 2006 and 2005

NOTE E: ADMINISTRATIVE AND INVESTMENT EXPENSES

The following provides additional details related to administrative and investment expenses for the year ended June 30, 2006:

<u>Administrative expenses</u>	<u>2005/2006</u>
Actuary	\$ 16,300
Attorney	2,132
Printing	80
Insurance premiums	<u>72</u>
	<u>\$ 18,584</u>
 <u>Investment expenses</u>	
Chicago Equity	\$ 69,416
Cook Mayer	42,485
Duff & Phelps	17,982
Gray & Co.	15,000
Northern Trust Co.	11,314
Other	<u>13,229</u>
	<u>\$ 169,426</u>

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MANAGEMENT LETTER

To the Executive Director and
Members of the Board of Directors
City of Ann Arbor Retiree
Health Care Benefits Plan and Trust

As you know, we have recently completed our audit of the records of the City of Ann Arbor Retiree Health Care Benefits Plan and Trust (VEBA Trust) for the year ended June 30, 2006. In connection with the audit, we feel that certain changes in your accounting and administrative procedures would be helpful in improving management's control and the operational efficiency of the accounting and administrative functions. This suggestion is a result of our evaluation of the internal control and our discussions with management.

GASB Statement No. 43 is effective for this fiscal year.

The Governmental Accounting Standards Board has recently issued Statement No. 43, *Financial Reporting for Postemployment Benefit Plans Other than Pension Plans*. GASB 43 provides guidance to employee benefit plans such as the VEBA Trust with respect to new financial reporting requirements. The new rules will cause changes to the financial statements and required disclosures. The new pronouncement is effective for the City of Ann Arbor VEBA Trust the year ended June 30, 2007.

One of the most significant requirements of GASB 43 is the inclusion of certain actuarial information that is not required or disclosed for the current or past fiscal years. A Schedule of Funding Progress will be required that will disclose funding progress in relation to the Annual Required Contribution, or ARC. The ARC will be calculated annually by the actuary and will be composed of two components: required contributions for current employee service and required contributions for past employee service. Calculation of the ARC requires an amortization period of past service cost of no longer than thirty (30) years. Preliminary actuarial information for the fiscal year ended June 30, 2006 places the ARC at about twenty (20) percent of the City of Ann Arbor's annual payroll, or about \$10,000,000 for fiscal year 2006-07. The VEBA Trust will not be required to initially record any asset or liability because of GASB 43, but only to disclose funding progress in relation to the ARC.

GASB 43 is the "companion" pronouncement to GASB Statement No. 45, *Accounting and Reporting by Employers for Postemployment Benefits Other Than Pensions*. The Plan sponsor, the City of Ann Arbor, will be required by GASB 45 to recognize in its financial statements an asset or liability for any excess or deficiency of contributions to the VEBA Trust over or under the ARC. According to the VEBA Trust financial statements for the year ended June 30, 2006, the City contributed \$7,065,913 to the Plan. If the ARC is \$10,000,000, the City would be required to record a liability in its Statement of Net Assets for this deficiency. This liability will go up each year because of accrued interest and will change also based on future differences between the actual contribution and the ARC.

We would like the Board of Directors to be aware of this upcoming change and also suggest that discussions be held with the City of Ann Arbor to initiate the planning process for implementing this new standard.

This condition was considered in determining the nature, timing, and extent of the audit tests to be applied in our audit of the basic financial statements, and this report does not affect our report on the financial statements dated September 27, 2006.

This report is intended solely for the information of management, and members of the Board of Directors of the City of Ann Arbor Retiree Health Care Benefits Plan and Trust and is not intended to be, and should not be, used by anyone other than these specified parties.

We wish to express our appreciation for the courtesy and cooperation extended to us during our audit. We are available to discuss this suggestion with you and to provide assistance in the implementation of improvements.

Abraham & Gaffney, P.C.

ABRAHAM & GAFFNEY, P.C.
Certified Public Accountants

September 27, 2006